

Audit Committee Forum™

Discussion Paper 5

The Corporate Laws
Amendment Bill and the
developing role of the
audit committee

The Corporate Laws Amendment Bill and the developing role of the audit committee



The information contained in Position Papers disseminated by the Audit Committee Forum™ is of a general nature and is not intended to address the circumstances of any particular individual or entity. The views and opinions of the Forum do not necessarily represent the views and opinions of KPMG, the Institute of Directors and/or individual members. These guidelines are for discussion purposes only and in considering these issues, the culture of each entity should be taken into account as must the charter for each entity's audit committee. Although every endeavour is made to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No reliance should be placed on these guidelines, nor should any action be taken without first obtaining appropriate professional advice. The Audit Committee Forum™ shall not be liable for any loss or damage, whether direct, indirect, consequential or otherwise which may be suffered, arising from any cause in connection with anything done or not done pursuant to the information presented herein.

Introduction

During October 2005, the Audit Committee Forum hosted a Roundtable discussion focusing on the Corporate Law Amendment Bill (the Bill). This Roundtable was attended by audit committee members, directors and other interested parties and it was evident from these discussions that directors and audit committee members were generally concerned regarding the unintended consequences these changes will have on the South African business environment. Many of these consequences we believe will result in the objectives of the Bill not being achieved.

The objective of this Discussion Paper is to create an awareness of these unintended consequences and the Audit Committee Forum™ wishes to invite contributions and comments that can be further debated. The final Position Paper on this topic will be issued once the final Companies Act amendments have been enacted and will deal with additional practical guidance to audit committees on how to adapt to the developing role of the audit committee.

Background

The collapse of Enron in the United States and the allegations of wrong doing against its management and its auditors have been widely commented upon in the media since 2001. In South Africa we have had several corporate failures and Finance Minister Trevor Manuel is on record in

his 2002 Budget speech as alleging areas of weakness in South African corporate governance and initiating a full review of corporate and auditing legislation and commissioned a Panel to research various aspects of South African legislation with a view to strengthening corporate governance and protecting public interest.

Corporate Laws Amendment Bill

The outcome of the Panel deliberations was new legislation affecting directors and auditors. The first Act to be passed was the Auditing Profession Act (please refer to position paper 12 for more detail on this Act) and now the Corporate Laws Amendment Bill (the Bill). This interim amendment to the Companies Act 26 of 1973 will form part of the law reform planned for 2007, during which substantial changes will be made to the South African Companies Act.

The impact on the composition of the audit committee

The Bill requires every Widely Held Company¹ to establish an audit committee with a minimum of two members and consisting only of non-executive directors who must act independently.

The Audit Committee Forum™ does not support this requirement. The concept of composition of an audit committee is currently debated internationally and requiring 'only non-executive directors who act

¹ A company is a widely held company if:

- its articles provide for an unrestricted transfer of its shares;
- it is permitted by its articles to offer shares to the public;
- it decides by special resolution to be a widely held company; or
- it is a subsidiary of a company described in any of the above.

independently' will further reduce the limited pool of experienced directors willing and able to serve on audit committees.

In fact, all directors are required to act independently (as envisaged by the King code and law), and audit committees should continue to comprise "independent" non-executive directors (refer to Appendix A for the criteria for independent non-executive directors).

Entities may experience difficulties in appointing only "independent" non-executive directors where the audit committee currently comprises three to five members.

In these cases a practical solution for these entities may be to appoint the minimum number of audit committee members and to provide the required support to the audit committee through inviting other directors / advisors to the audit committee meetings. The charter for the audit committee should clearly define the roles of any invited attendees.

Audit committees operating in this manner will place additional responsibilities on the chair of the audit committee to gather the information needed to take appropriate decisions and fulfil the audit committee responsibilities and the chairperson will also have to seek input from legal and other advisors as appropriate.

Although the Bill does not specifically require any members of the audit committee to be financially literate, the Audit Committee Forum™ strongly recommends that at least one member of the audit committee

be regarded as financially literate.

The impact on the responsibilities of the audit committee

Traditionally, the audit committee is responsible for:

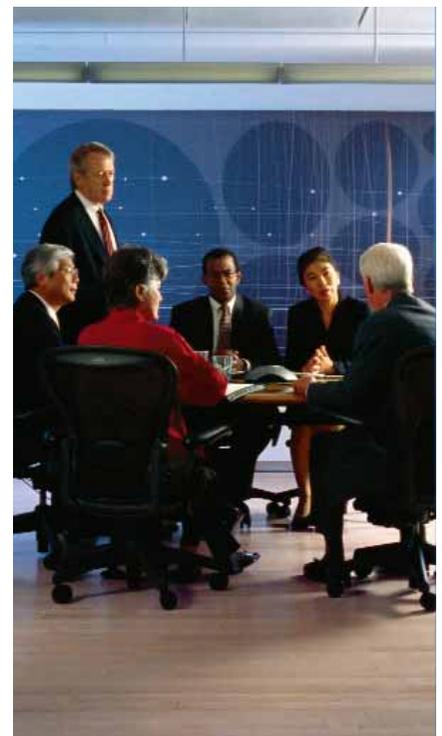
- Oversight of public financial reporting (annual, half-yearly, quarterly and cautionary announcements);
- Oversight of the audit process (both internal and external); and
- Oversight of risk management and controls.

The Bill places additional responsibilities on the audit committee, over and above the traditional responsibilities as listed above. In terms of the recommendations of the Bill, the following additional responsibilities should be added to the audit committee's charter:

- Nominating a registered auditor for appointment who, in the opinion of the audit committee, is independent of the company.
- Determining the fees to be paid to the auditor and the auditor's terms of engagement.
- Ensuring that the appointment of the auditor complies with the Companies Act and any other legislation relating to the appointment of auditors.
- Determining the nature and extent of any non-audit services which the auditor may provide to the company.



- Pre-approving any proposed contract with the auditor for the provision of non-audit services to the company.
- Inserting in the financial statements a report:
 - describing how the audit committee carried out its functions; and
 - stating whether the audit committee is satisfied that the auditor was independent of the company.
- Receiving and dealing appropriately with any complaints (whether from within or outside the company) relating either to the accounting practices and internal audit of the company or to the content or auditing of its financial statements, or to any related matter.
- Performing other functions determined by the board.





Guidelines to the audit committee in fulfilling these responsibilities

The Audit Committee Forum™ suggests the following processes and procedures to implement the requirements of the audit committee of a widely held company. These suggestions should be evaluated in line with the charter of the individual audit committee as well as in line with the resources available to the audit committee.

Evaluating the independence of the auditor

In evaluating the independence of the external auditor, the audit committee should, in relation to the company, any subsidiary, or parent, or any member of the group:

- Ascertain that the auditor does not, except as auditor or rendering permitted services, receive any remuneration or benefit;
- Consider the extent of consultancy, advisory and other services undertaken by the auditor;
- Consider whether the auditor's independence is prejudiced by previous appointment as auditor; and
- Consider the external auditor's compliance with independence criteria specified by the Independent Regulatory Board for Auditors (IRBA).

At present the independence criteria specified by the IRBA is the same as those issued by the Independent Federation of Accountants (IFAC) and requires the auditor to be independent in fact and appearance. The overriding principle is that the auditor should not be placed in a position where non-audit services delivered by the auditor will be subjected to his/her own audit procedures during the financial statement audit. (Please refer to Position Paper 4 for guidelines on evaluating non-audit services).

This formal evaluation must be performed by the audit committee before appointing a new external auditor. An informal evaluation process must be performed on an annual basis as addressed later in this paper.

Determining the fees to be paid to the auditor and the terms of the engagement

In terms of the Bill, the audit committee is responsible for setting the fees for the audit engagement. Practically in the past, audit committees were advised of the negotiated fee by management.

In determining the fees to be paid to the external auditor, the audit committee should seek input from management regarding their expectations; however the final fee negotiations should include only the audit committee and the external auditor.

In determining the terms of the engagement, the audit committee should understand the planned scope of the audit particularly in the group situation where the audit committee should have an understanding of the components of the group such as ²:

- those that are financially significant and will require a full scope audit;
- those that are significant as a result of specific risks and may require agreed-upon procedures addressing the identified risks specifically, or a full-scope audit;
- those that are not individually significant but are significant when aggregated with other components. These types of components may require a review engagement only; or
- those that are not significant at all, in which case analytical procedures may constitute sufficient audit work.

The audit committee should be aware that components that are statutory entities still require an audit of the financial statements, but the guidelines above will be sufficient for group audit purposes.

² In terms of the IFAC Exposure Draft ISA 600: The audit of group financial statements



Appointment of the auditor

The formal appointment of the external auditor remains the responsibility of the board of directors and the shareholders of an entity, and the audit committee is responsible for nominating an external auditor after performing the evaluation of competence and independence.

The audit committee must perform an evaluation of the independence of the external auditor as discussed above in situations where the board or shareholders elect another external auditor (other than the auditor nominated by the audit committee).

It is advisable for the audit committee and the board to establish a dispute resolution process for situations where the audit committee and the board disagree on the external auditor to be appointed e.g. where the audit committee is not satisfied with the independence of the external auditor appointed by the board and shareholders.

Nature and extent of audit services

The external auditor of a widely held company may not, for the duration of the appointment, perform services for that company that are prohibited under the code of professional conduct established by the IRBA.

The IFAC principle of independence, as adopted by the IRBA, requires that the external auditor does not provide any services which will be subjected to his/her own audit procedures during the audit of the financial statements.

The auditor is also not permitted to perform the following for audit clients:

- be placed in an advocacy role for the audit client;
- perform management functions; and
- take management decisions.

Pre-approving any contract for non-audit services by the external auditor

The audit committee is required to pre-approve any contract for non-audit services to be provided by the external auditor. Practically, this requirement may be difficult to implement where the audit committee meets only once per quarter.

There are many ways of meeting this requirement including following a 'round-robin' resolution approach, the responsibility may be delegated to the chairperson of the audit committee or a formal pre-approval policy may be used.

It is suggested that the audit committee establish a pre-approval policy for non-audit services, which clearly outlines the types of services permitted as well as clear guidelines regarding the communication of these services to the audit committee.

(Position paper 13 will address this requirement in more detail and will provide guidance on establishing and implementing a pre-approval policy).

Inserting a statement in the financial report

The audit committee is required to insert a statement in the financial statements (annual report):

- describing how the audit committee carried out its functions; and
- stating whether the audit committee is satisfied that the registered auditor was independent of the company.

The manner in which the audit committee carried out its functions should address the following:

- a statement that the audit committee reviews the Financial Statements and recommends them for approval to the Board of Directors;
- the size and composition of the audit committee;
- the number of meetings held during the financial year;
- the number of meetings attended by each member of the audit committee (as is required by the PFMA and the JSE Listing requirements);
- a statement that the audit committee operates as a sub-committee of the board;
- a statement that the audit committee operates in line with a charter as approved by the board of directors; and
- a statement that the audit committee fulfils its responsibilities in line with the Bill and the King II code on corporate governance.



All audit committee members should be fully conversant with the entity's audit committee charter and the provisions of King II.

The statement regarding the independence of the external auditor will require that the audit committee perform an informal evaluation of the independence of the external auditor which may entail the following:

- obtaining a representation letter from the external auditor regarding his/her independence from the entity (this representation is also required in terms of the International Standard of Auditing 260: communication with those charged with governance); and
- evaluating the policies and procedures implemented by the external auditor to ensure continued independence from the entity.

Receiving and dealing with complaints

The audit committee is required to "receive and deal appropriately with complaints (whether from within or outside the company) relating either to the accounting practices and internal audit of the company or to the content or auditing of its financial statements, or to any related matter."

One of the effective manners of fulfilling this responsibility is the establishment of a whistleblower hotline. Please refer to Position Paper 11 dealing with the role of the audit committee in establishing and evaluating a whistleblowing hotline.

The audit committee should also be aware of the external auditor's responsibility to report irregularities in terms of the Auditing Profession Act and the impact on the audit committee. This topic is dealt with in more detail in Position Paper 12.

The way forward

If audit committees are to fulfil their responsibilities then boards need to create mechanisms that encourage the selection and retention of diligent and knowledgeable audit committee members who are dedicated and willing to devote a substantial commitment of time and energy to their audit committee responsibilities.

Audit committees should consider industry specific training initiatives that ensure their members remain up to date with current developments in accounting, auditing standards and relevant legislation. To determine their needs, committee members should recognise any gaps in their knowledge and consult with management, internal audit and external auditors as necessary.

Audit committees should consider the effect of the Bill before its enactment, as the Bill does not contain or allow for transitional arrangements for the establishment of an audit committee for widely held companies. The impact of this could be that any widely held company will be in immediate non-compliance of the Companies Act on the effective date.



Appendix A

The role of the non-executive director

The perceived failure of corporate governance in recent corporate failures has led to questions being asked about what the role of independent non-executive directors should be. Non-executive directors are normally appointed to the board of directors primarily for their contribution to the development of the entity's strategy, but they have a control and monitoring function too through membership of the main board and the audit, remuneration and other committees. In some smaller entities non-executives may contribute valuable expertise not otherwise available to management or may act as mentors to less experienced executives.

The Bill defines a director as non-executive if the director:

- "is not involved in the day to day management of the business and has not in the past three financial years been a full-time salaried employee of the company or its group;
- is not a member of the immediate family of an individual mentioned above or involved in the day to day management of the business".

It is the view of the Audit Committee Forum™ that to be effective in their role, independent non-executive directors should:

Be independent, in fact and appearance as relationships, whether personal, business, political or philanthropic may compromise their independence and therefore their ability to actively challenge management.

"A director acts independently if that director:

- expresses opinion, exercises judgement and makes decisions impartially;
- is not related to the company or to any shareholder, supplier, customer or other director of the company in a way that would lead a reasonable and informed third party to conclude that the integrity, impartiality or objectivity of that director is compromised by that relationship³."

Be given timely access to all relevant information, so that they can consider and discuss it before important decisions are taken.

Be dedicated – the role requires a considerable time commitment and non-executive directors should devote sufficient time and energy to their responsibilities. They should be prepared to spend the time necessary to learn and stay up-to-date about the entity and its business.



Be remunerated for this commitment.

Only accept appointment to an appropriate number of non-executive directorships to enable them to perform their role effectively.

Actively communicate, both formally and informally, with other non-executives.

Be fully aware of the significant risks faced by the group as is addressed in Position Paper 6.

Take an active role in the board's review of the effectiveness of the system of internal control.

As members of the audit committee, **be able to understand** the principles that underpin the preparation of financial statements. The audit committee should seek expert advice for complex matters.

As members of the remuneration committee, **have access** to professional advice on remuneration matters from both inside and outside the entity, and be sensitive to the wider scene, including pay and employment conditions elsewhere in the group and similar entities.

³ Corporate Laws Amendment Bill



Appendix B

Other amendments included in the Bill Section 38

Section 38 is amended by allowing a company to provide financial assistance for the purchase of or subscription for shares of that company or its holding company, if:

- subsequent to the transaction, the consolidated assets of the company fairly valued will be more than its consolidated liabilities; and
- subsequent to providing the assistance, and for the duration of the transaction, the company will be able to pay its debts as they become due in the ordinary course of business; and
- the terms of the assistance must be sanctioned by a special resolution

Appointment and rotation of the auditor

The Bill stipulates that in the case of a firm being appointed as auditor, the name of the individual responsible for the audit (the 'designated auditor') must be included in the contract and in the audit opinion. This 'designated' auditor will rotate every five years, measured from the date of the auditor's first appointment or reappointment after the date of the Act when promulgated.

The designated auditor may also not be reappointed as the designated auditor of that company until after the expiry of at least two further financial years.

Financial reporting standards

Widely held companies must comply with the financial reporting standards⁴ which will be approved through Government Gazette, thereby providing legal backing to the financial reporting standards.

It will be considered an offence for directors to issue incomplete or non-compliant financial statements.

"Limited interest companies must comply with the standards developed for limited interest companies". It is the responsibility of the Financial Reporting Council to develop these standards. "Prior to the development of these standards, a limited interest company must prepare its financial statements in accordance with a set of accounting practices adopted by that company. These accounting practices must comply with the framework for the preparation and presentation of financial statements included in the financial reporting standards".

The accounting practices must be appended to any financial report that is based on these practices.

⁴ Financial reporting standards means statements of Generally Accepted Accounting Practice adopted by the Accounting Practices Board prior to the establishment of the Council, and thereafter issued in terms of section 440U(2). [Currently these standards are the International Financial Reporting Standards]

Contact details:

Lindie Engelbrecht

ACF National Co-ordinator

011 647 8778 or

lindie.engelbrecht@kpmg.co.za